

## **SMALL AND MEDIUM-SIZED ENTERPRISES AND COMPETITIVENESS**

The Center for Economic Development (CED) has conducted a survey on the effects of tax, trade and financial policies on the competitiveness of the SME sector, including an overview of government institutions implementing SME development policies. Through this project, realized within the DemNet Program, the CED furthered its involvement with competitiveness issues as part of its overall effort in that direction over the past three years. The present study analyzes the impact of some of the diverse factors working on the competitive environment in which Bulgarian SMEs develop, and suggests specific recommendations and measures to enhance SME competitiveness.

The national competitive environment affects the strategic choices of SMEs, within their specific industries, through the range of mechanisms and tools available to business players. The role of the government is to set up an effective environment in which competitive SMEs can emerge. There are a number of factors at play which affect the individual businesses and largely determine their priorities, strategic choices and behavior patterns.

The issues pertaining to improving SME **competitiveness** are a priority, since competitiveness is a feature that characterizes a nation's capacity to achieve high productivity rates, which is based on an innovative approach to human resources, capital and fixed assets. Such an approach makes it possible to face the challenges of and contest on international free markets.

Improving competitiveness is a key to achieving economic growth, sustaining the competitive pressures within the EU, and adequate participation in the global division of labor. When we talk about competitiveness, we mean both the competitiveness of the national economy and that of the individual industries and businesses. It is necessary to consider the relationships and interactions of any economy, in order to define its overall potential to generate growth..

Taking advantage of the challenges offered by modern development assumes the existence of a favorable environment fostering SME development. Against this backdrop, the issue of the **role of the government** stands out with particular prominence. This involves the legal framework, administrative capacity, institutions, regulatory instruments; and not as a matter of principle but, rather, from the perspective of their effect on business practices and strategies.

Is there a need for a pro-active policy to improve SME competitiveness, or should everything be left to happen as it may? Should we continue to neglect their competitiveness, or should we undertake measures to improve the environment in which they emerge and develop, and what exactly should such measures involve? Through this study, CED attempts at mapping out some starting points for an in-depth discussion among the professional communities on the priority actions that need to be undertaken to promote the SME sector in Bulgaria.

## **THE IMPORTANCE OF SMALL AND MEDIUM-SIZED ENTERPRISES FOR THE BULGARIAN ECONOMY**

International experience in the development of each and every national economy provides ample evidence for the **priority role of the SME sector** in the emergence and sustenance of a competitive market economy and in attaining the optimal diversification in terms of business size. SMEs are a source of job creation, they provide an incentive for the development of entrepreneurship skills, they enhance competition and reduce regional variances in economic efficiency.

The basic rationale for **government support** for SMEs is that, on the one hand, SMEs lack the competitive edge needed to secure financing. There is also the relatively higher administrative cost involved in complying with government regulations, including tax legislation. They find it difficult to access information about innovations. On the other hand, there is the argument that such companies are much more flexible and dynamic and, hence, contribute to overall economic growth.

Establishing an economic environment conducive to the efficient operations of the various small and medium-sized enterprises is a difficult and lengthy process. Along with the many shortfalls in that regard, which are still to be overcome, there is also the need to set up an up-to-date tax system and provide opportunities for financial incentives. The Government of Bulgaria has developed and adopted a National Strategy to Promote SME Development, with a major thrust on creating a favorable institutional, regulatory, administrative, financial and competitive environment that stimulates SMEs. Some of the short-term initiatives set out in the Program have already been implemented, including the adoption of the Small and Medium-sized Enterprises Act.

According to 1998 data provided by the National Statistics Institute (NSI), **98.5% of all enterprises belong to the SME sector** (or, a total of 205 643 entities, not including private agricultural farms that do not enjoy the enterprise status). To compare, SMEs account for 99.8% of all enterprises in the European Union, providing 66% of all jobs. Bulgaria's SME sector generates **48% of total income** and holds **22.8% of the long-term tangible assets** of all businesses. In 1998, the number of people employed with SMEs increased by 51 742, representing 88.74% of the reported decrease in the national unemployment figure (total of 58 305). This fact indicates that small and medium-sized businesses are becoming a major factor in bringing down unemployment and in job creation.<sup>1</sup>

In 1998, SMEs generated **46.2% of the sales** of all enterprises. Their share in the **gross value added** for that year stood at **25.38%**.<sup>2</sup>

The 1998 **net profitability rate** (as a ratio between the net financial result and income from operations) achieved by the economy as a whole was 0.69%, compared to 3.21% for micro businesses, 0.03% for small businesses, and 0.05% for medium-sized businesses, respectively. It is also noteworthy that, in the 1996 - 1998 period, it was only micro businesses that reported a positive net profitability rate in each of the three years, whereas, in the economy as a whole, companies reported a negative profitability ratio of -0.85% in 1996, and the largest companies (with over 250 people employed) reported a negative profitability rate of -0.25% in 1998 as well. Overall data indicate that SMEs exhibit a higher degree of flexibility and revamp much faster after spells of downturn.

The share of SMEs in the 1998 **employment** figure totals **44.1%** (having accounted for 36.7% of all employment in 1996, and 41% in 1997, respectively). Considering the fact that **the average Bulgarian enterprise provides 8 jobs**, it can be concluded that SMEs hold a considerable potential to hire additional employees, provided that the conditions favorable for expanding their operations are in place. This could reduce the relatively high unemployment rates, both regionally and nationally.

In 1998, SMEs accounted for **38.52% of imports** and **22.12% of exports**.<sup>3</sup>

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<sup>1</sup> The 1999 Annual Report of the Agency for SMEs .

<sup>2</sup> *SMEs in the Republic of Bulgaria in 1998*, An NSI publication, 1999.

<sup>3</sup> *SMEs in Bulgaria, 1996 -1999 Report*, Bulgaria, Agency for SMEs, FED, CED, 2000.

In summarizing the conclusions from recent studies and analyses of the SME sector, we could formulate its primary advantages. SMEs are:

- A source of increasing market competition;
- Job-creators;
- More flexible in crisis periods;
- Dispose with a flexible internal organizational structure and a capacity to implement innovations and new technology more quickly and easily;
- A favorable place to develop entrepreneurship skills and foster business culture;
- Closer to ultimate customers and capable of responding to their needs in a timely and efficient manner.

The **legal framework** for the development of small and medium-sized enterprises in Bulgaria involves a wide range of primary and secondary legislation regulating various aspects of their activity, as well as the various industries within the national economy. One reason for that lies in the time of the adoption of the Small and Medium-sized Enterprises Act (the SME Act), which occurred at the end of September 1999, coming relatively late in comparison to other regulations dealing with Bulgaria's economic development. This determined the need to align the SME Act with the regulations already in place, so as to avoid any conflict with, or repetition of, their provisions.

The **principal regulatory achievements** to be found in the SME Act include: a comprehensive definition of the terms "micro", "small" and "medium-sized" enterprise, a definition of the statute of the Agency for SMEs and its main responsibilities; the establishment of an Advisory Board for Small and Medium-Sized Enterprises as a consultative government/public body attached to the Agency for SMEs; a definition of the statute of a Promotion Bank JSC as a lending institution financing SMEs<sup>4</sup>; preferential treatment available for SMEs in privatization proceedings and in leasing state and municipal real property; establishment of an earmarked Guarantee Fund to cover part of the credit risk, establishment of an SME registry; information support and training for SMEs. At the same time, it is generally felt that **the real effect of implementing this Act is yet to come**. For instance, there is still no information about specific cases where SMEs have availed of the above-mentioned preferential terms.

The overall **legal framework** pertaining to the SME sector shows a certain degree of **inconsistency, instability and incoherence**. The procedures it lays down are lengthy and complicated. There are too many automatic and non-automatic licensing regimes, regulatory gaps and a lack of specific mechanisms to promote SME development. The absence of a specialized, uniform legal framework for the development of SMEs hampers SME operations. There are no tax breaks and financing schemes beyond those set in the banking law. This does not stimulate adequately SME development and sustainability. Future efforts should focus on eliminating the current difficulties and an enhanced harmonization among the various regulations.

The general regulatory framework for SME development is already in place. Within the overall legislation, however, there is a certain inconsistency and instability, and the effect this has on SME development is unfocused and inherently contradicting. Obviously, there is **a need to amend and supplement the existing legal framework** and improve application practices so as to create a general environment conducive to the development of entrepreneurship and achieve

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<sup>4</sup> Under the most recent amendments to the SME Act as enacted in November 2000 and taking effect as of 2001, the Promotion Bank is to lend no longer "exclusively to SMEs", as originally stipulated, but "primarily to SMEs", a rather general provision that does not imply any specific dimensions for that prioritization.

harmonization with the EU *acquis communautaire*. Moreover, the European Commission Progress Report on Bulgaria's accession efforts in 2000<sup>5</sup> recommends to adopt, in Bulgarian law, the definition of the European Commission for SMEs, particularly in terms of the size of micro, small and medium-sized enterprises.

The **basic difficulty** with small and medium-sized enterprises stems from their **heterogeneity**. Whether it is a case of a family business aimed merely at providing a certain type of service or supplying goods (foodstuff and the like) to a neighborhood, or a new business venture targeting a certain market niche related to manufacturing, it is not possible to pinpoint any activities as typical of small and medium-sized business operations. Despite their diversity, it is possible, however, to determine the potential advantages and disadvantages of small enterprises.

A major advantage of small businesses lies in their organizational structure and resilience to external shocks. The small number of persons employed, the absence of a bureaucratic structure and the ease of reengineering their production capacity makes them particularly strong in sustaining a time of crisis. Their flexibility in making efficient, quick changes in terms of production, and the engagement in several lines of operation simultaneously are traditionally associated with small and medium-sized business and serve as a potent factor in its competitiveness. Over the past years, **flexibility and adaptability** of small business has shown a considerable growth due to the advent of computers.

Typically, small businesses are characterized with **relatively high compliance costs in terms of tax law and other form of government regulation**, particularly if involved in international operations. Compliance costs may have monetary implications (such as paying tax advisor fees or salary payments to personnel dealing with tax issues), time cost implications (the time spent by a taxpayer to handle their own or someone else's tax issues) and physiological cost (anxiety, stress, apprehensions related to possible mistakes or a possible audit by the tax authorities). Bulgarian companies, and particularly those in the SME sector, encounter an increasingly complex legal, tax and administrative environment in starting up and developing their business.

Legislation is a necessary regulator to protect the business environment, to ensure employees health and safety, to lay down the respective social security regulations. At the same time, however, it hampers business by imposing **additional costs and administrative barriers** that create inequality between small and large businesses. Large companies may assign a portion of their staff to deal exclusively with studying new regulations and ensuring compliance of company operations. For SMEs, this would be a high cost, given the size of their business. For EU companies, the administrative burden has been estimated at 180 to 230 billion Euro per year. According to a survey of the relative costs of the administrative burden per capita, in SMEs, this cost is up to 20 times higher than in large companies.<sup>6</sup>

For SMEs, **difficulties** begin as early as in the **start-up stage** of their life cycle. In the European Commission Recommendation on the improvement and simplification of the business environment for start-up business dated 22 April 1997, it is suggested that the Member States should set up a "one-stop shop" service arrangement for all formalities involved in the establishment of a company, use a single registration form and a single ID number, and facilitate registration procedures. The Recommendation also advises member countries to stimulate businesses during their early years of existence by simplifying tax, social and statistics obligations.

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<sup>5</sup> 2000 Regular Report of the European Commission on Bulgaria's Progress towards Accession, p. 65

<sup>6</sup> Data source: European Commission Communiqué from 1996 on the Integrated Program for the SMEs and Handicrafts Sector.

Policy with respect to this type of companies is influenced by the fact that **small business plays a key economic role in terms of production capacity, employment, innovation potential and, hence, the competitiveness of the respective industry or the national economy as a whole.** Small business development may be stalled or stunted by a number of economic and other factors that can, to a certain extent, be neutralized or ameliorated through adequate government intervention. Conversely, any misjudged government initiative may slow down, or even destroy, small business.

In this respect, the main issues to be addressed by any government stating its support for small and medium-sized business include:

- Identification of all specific barriers to small business start-up and growth;
- Finding an answer to the question of which barriers can and should be neutralized or ameliorated through government intervention;
- Deciding what action should be undertaken in that direction: whether to apply tax or non-tax measures to promote small and medium-sized enterprises.

Comprehensive government policies and specific measures in this area should, by any means, be applied while taking into consideration the general economic advantages and disadvantages in national development. It is not possible to apply measures that might infringe on the interests of other economic agents in a free market environment.

## **FINANCING SMALL AND MEDIUM-SIZED ENTERPRISES**

Financing Bulgarian SMEs is one of the key prerequisites for the future development of the national economy and the achievement of economic growth. It would require special commercial bank financing targeted at the SME sector, as to implement it. Currently, commercial banks apply a conservative policy in lending to SMEs. Most banks prefer to hold mostly risk-free and low-income generating assets, and SME lending is unattractive due to a range of objective and subjective factors. These include high transaction costs involved in extending small loans, inability to set up the collateral required, etc. Naturally, the SME sector is not homogeneous and, therefore, the attractiveness of an enterprise to financial institutions varies with SME size, maturity, industry, etc. The specific characteristics of lending to SMEs has led to the development of a number of financial instruments especially designed for SMEs such as:

- Micro-lending facilities;
- Equity financing;
- Credit guarantee facilities, etc.

The policies of international financial institutions such as EBRD as regards SME financing usually focus on offering products directly addressing SMEs, or aim at strengthening the banking system in order to ensure access to banking services for small businesses. The most common formats to do that include:

- Participation in venture capital funds;
- Equity participation in local banks in order to increase their capital base and strengthen corporate governance;
- Extension of interbank loans;
- Co-financing for local projects in cooperation with local and international banks;
- Offering apex creditlines secured by government guarantees.

According to the effective legislation, bank lending is subject to licensing and strict supervision. A bank is “a joint-stock company engaging in public acceptance of deposits and using the funds thus attracted to make loans and to invest for its own account and at its own risk”. The bank may also engage in the following commercial operations related to financing: guarantee transactions, management of investment funds, factoring, financial leasing and the acquisition and management of equities (under specific conditions). The Banking Act also defines the total amount of bank investments in real property and other long-term tangible assets as a ratio to its own equity.

In its Regulation No. 9, the Bulgarian National Bank (BNB) sets the criteria for evaluating **risk exposures** of banks and for setting up loan loss provisions. In practice, banks evaluate SMEs as credit applicants of high risk and require collateral in excess of 125%, depending on the life of the loan: the longer the term of a loan, the higher the guarantees sought by the bank. Banks look for high-liquidity collateral (such as gold, blocked deposits in national or foreign currency, government securities or half of the value of a first mortgage). Mortgages on real property are not valued very highly since real property has low liquidity and objective value appraisals are a problem. The latest amendments to Regulation No. 9 prescribe that the credit exposure can be reduced only in the case of a mortgage on a housing real estate, and the bank has to set up loan loss provisions on the entire amount of the loan, if secured by any other type of realty.

According to Article 37 of the Banking Act, **interest rates** on loans and deposits are negotiated between the borrower, or depositor, respectively, and the bank. At the same time, according to Article 2 of Ordinance No. 5 of the Council of Ministers effective as of 1991, interest rates on loans, deposits and savings accounts in the national currency are negotiated between banks and the borrower, or depositor, respectively, on a market basis, depending on the base interest rate and other interest rate levels determined by the BNB.

According to data provided in the Annual Report of the Agency for SMEs, the average interest rate on long-term loans made to private companies in Bulgarian leva in 1999 was 15%. The average lending rate on short-term BGL loans for private companies was 14% for the respective year. Interest rates charged on new loans denominated in US dollars stood at an average of 10% for short-term lending and 14% for long-term lending, respectively. Interest rates on new loans made in Euro averaged 9% for short-term debt and 11% for long-term debt.

Following the introduction of the currency board arrangement and the strengthened supervision by the BNB, commercial banks have become quite precautionary in extending new loans. Currently, this policy has not exhibited any noticeable change. The most common loans are **short-term working capital loans**, in the existence of a high-security collateral (between 110% and 150% of the amount of the loan requested), and mostly to customers with a sound record of creditworthiness. Despite the persisting downward trend in the base interest rate, lending rates retain relatively high levels.<sup>7</sup>

From the perspective of the regulations that came into effect after 1997, commercial banks are better protected in their lending operations. Nevertheless, from the banks' perspective, **collecting on creditor claims is very difficult**.

Banks may require borrowers to submit financials and other documents related to their activity and to make verification inspections on the appropriate use of the loans disbursed and on the storage and quality of goods for which loan money has been used.

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<sup>7</sup> *SMEs in Bulgaria, 1996–1999 Report*, Bulgaria, Agency for SMEs, FED, CED, 2000.

According to a number of SME surveys done over the past several years, more than half of the companies in the sector rank financial problems (lack of start-up capital, lack of financing for working capital needs and lack of financing for investment needs) among the three major difficulties in the beginning of their operations. At the same time, only 20 to 30% of them have applied for loans. Reasons lie primarily in the terms under which credit resources are made available, and in the impossibility of SMEs to meet the respective requirements. Over recent years, the prevailing portion of requests have been for loans meeting working capital needs, and their typical size has been up to USD 10 000. The primary consideration for a commercial bank in extending a loan to a company or in refusing to accept an application has been the **level of loan security cover**, followed by the size of the company and its financial condition.

**Bank lending** is the prevailing form of financing for SMEs in EU countries, making up more than 55% of all borrowing. This includes standard bank lending, where enterprises apply under a general procedure followed by all economic agents, and specialized lending, including credit lines for SMEs, credit guarantee facilities, support programs, etc. Currently, bank lending in Bulgaria is severely limited. According to BNB data, as of 30 June 2000, only an approximate of 31.5% of all income-generating assets of the banking systems are in the form of extended loans. It could be sustained that **the country does not have a really developed credit market**. It is practically impossible for a small enterprise to obtain a standard loan. Bearing in mind that SMEs account for about 30% of GDP, this implies that practically one-third of Bulgaria's economy is deprived of bank financing. The problem is exacerbated by yet another reason: SMEs are a major source of employment in the economy, and the lack of access to financing seriously increases the risk of a rise in unemployment.

There are several **credit line facilities** providing loans to SMEs in Bulgaria: those of the German KfW bank, through the Bulgarian Eurobank and Union Bank, of EBRD through the Bulgarian American Credit Bank, Union Bank and SG Express Bank, and several credit lines set up by international financial institutions with First Investment Bank to finance the import of investment goods and services. The Promotion Bank, which was established pursuant to the SME Act, offers long-term investment loans with maturities of 4 to 10 years, and the resources are provided entirely from the bank's own funds. United Bulgarian Bank (UBB) provides loans to SMEs under a credit guarantee agreement with the United States Agency for International Development (USAID) up to USD 150 000. In cooperation with the Soros Foundation, the bank operates a micro-lending facility in the regions of Smolyan, Sliven and Kardzhali in partnership with the NGO Resource Center Foundation. As a rule, credit facilities from international financial institutions serve to provide access to financing for start-up, higher risk enterprises in regions with economic problems, etc.

Small and medium-sized enterprises encounter a range of **difficulties** in obtaining bank loans due to the following reasons:

- Lack of credit history;
- Size and type of collateral required;
- Interest rate levels;
- Inability of SMEs to make long-term financial projections and secure proceeds;
- High cost and cumbersome lending procedure and lengthy decision-making processes leading to insecurity and added cost to SMEs;
- Requirement for SME's contribution in financing the business project;
- Minimum sales income requirements or a high minimum amount of the extended loan;
- Additional requirements placed by banks;
- Unwillingness of commercial banks to make investment loans to SMEs;

- Other factors: excessive focus on collateral in decisioning loans, the wide access to bank secrets, etc.

Some of the major problems faced by commercial banks in lending to SMEs have to do with the following:

- Requirements for capital adequacy of banks, assessment of their risk exposures and loan loss provisioning requirements to hedge against credit risk;
- Certain BNB actions and decisions are inattackable in court, and there is a requirement for formal authorization by BNB for a range of transactions that are common in the course of normal banking operations;
- The law provides for criminal liability of officials for extending unsecured loans that have become default;
- Lack of consistency between National Accounting Standards and International Accounting Standards as regards lending;
- Frequent changes in tax provisions and the customs regime;
- Extremely difficult collection on creditor claims;
- The ban on the sale or pledge of assets of privatized enterprises for 10 years following acquisition.

The third group of issues has to do with the business environment, namely:

- Insecure and dynamic economic environment;
- Inadequate knowledge of economic and legal matters among credit applicants;
- Limited and underdeveloped domestic markets, which results in low liquidity of collaterals;
- Insufficient information about the borrower.

There are also some subjective problems such as the shortage of loanable funds of matching maturity with the banks, which limits the extension of long-term investment loans, and the insufficient training and motivation of banking personnel in working with SMEs.

According to the Small and Medium-sized Enterprises Act, the establishment and development of SMEs should also be promoted by **guaranteeing part of the credit risk** involved in loans extended specifically to SMEs. To this end, the Agency for SMEs has currently set up a working group to prepare a concept paper for the establishment of a guarantee fund to involve the government and a number of commercial banks. In the presence of risk sharing by such a fund, commercial banks will be more willing to finance SME projects, particularly in the area of high technologies, in regions with high unemployment, etc. Currently, under an agreement among the United States Agency for International Development, the Agency for SMEs and the UBB, the bank uses guarantees for its loan portfolio when lending to SMEs. The facility covers 50% of the credit risk associated with loan principals.

The application of **alternative forms of financing** SMEs in Bulgaria is but symbolic. These form include: venture capital financing, lease agreements, loan agreements, public offering of shares and issuance of bonds, corporate agreements.

Some of the principal lines along which the **conditions for SME financing can be improved** include: support for entrepreneurs in preparing the documents required to apply with financial institutions; setting up credit line facilities and lending schemes with international donors that share the risk with Bulgarian banks; risk sharing arrangements with insurance companies; introduction of a system for standardized SME loan extension and loan management with commercial banks; convergence of interests between banks and industry associations in order to



attain more favorable conditions for lending to SMEs; more active government support for SME lending.

## **TRADE POLICY, BILATERAL AND MULTI-LATERAL AGREEMENTS IN THE LIGHT OF BULGARIA'S ACCESSION TO THE EUROPEAN UNION AND THEIR EFFECT ON SME COMPETITIVENESS**

A definite achievement of the Bulgarian transition is the liberalization of trade. This was also the assessment given by EBRD experts of the progress made in the process of trade liberalization<sup>8</sup>. The legal grounds for government intervention in price formulation have been eliminated, the compulsory profitability rates and trade mark-ups have been removed. A mechanism of free price negotiation between manufacturers, traders and consumers has been introduced. **Government regulation** of prices of goods and services is now limited to the industries and operations of the natural monopoly type, and the goal there is for prices to recover the costs involved in the production, plus a minimal profit margin. The relative share of fixed prices in the consumer basket is 14%, which is comparable to that in developed market economies and the countries from the first group for EU accession. All goods are taxed at a single VAT rate, thus precluding the possibility for administrative intervention in pricing through rate diversification. All of this creates a suitable environment for establishing competitive SMEs.

Along with the other economic regulators, Bulgaria's **foreign trade policy** provides conditions facilitating the development of competitive companies, including SMEs. The goal of this policy is to ensure a balance between the need to retain a certain level of employment and income, and the efforts to stimulate national competitiveness on the basis of openness to the direct influences of global competition. The **foreign trade regime and customs tariffs** applied are key tools in the overall realignment of the economy. The liberal and stable foreign trade regime provides a business climate favorable to the functioning of SMEs.

The Customs Act that has been in effect for more than a year allows for considerable harmonization with the EU customs regulations. Tariff policy measures are aimed at achieving a stable and predictable business environment. The favorable effect of trade liberalization can be seen in the lowering of prices of goods and, hence, in the increased purchasing power of consumers. The stronger presence of foreign companies accelerates the process of restructuring the national economy by enabling the market to oust non-viable production and companies and to re-direct available resources to more efficient operations. This enhances the market orientation of SMEs.

Analysis of the degree of liberalization of prices and trade indicates that, in many respects, this liberalization exceeds the level achieved by the countries from the first wave of EU accession.

**Trade agreements** place new opportunities for expanding SME exports by creating a better environment for their exports, without any direct promotion measures. For SMEs to use those opportunities, however, they should be made well known. Companies should joint their awareness of the agreements with a sufficient degree of flexibility, in order to make their output competitive. Otherwise, it is their trade partners that benefit from the advantages of trade agreements, thus further reducing the competitiveness of Bulgarian SMEs.

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<sup>8</sup> EBRD Transition Report 1999, p.202

One of the key priorities for **Bulgaria's multilateral trade and economic policy** is its participation, on equal terms, in the process of further liberalization of world trade. **Bulgaria's membership in the WTO** is the basis for regulating its economic relations with the rest of the world. The advantages of this membership consist in an improved access of Bulgarian export products to national markets of WTO Member Countries and a progressive lowering of tariff and non-tariff barriers, and in a national treatment of Bulgarian goods (to be followed by capital, services and labor) on those markets. The latest amendments to the Bulgaria's foreign trade regime came as a direct consequence of WTO membership and the agreements reached with international financial institutions.

The purpose of this policy is to reduce consistently the protection and support for certain industries in the Member Countries. Bulgaria, however, does not apply export subsidies, and, at this stage, the issue at hand is the inequitable status of Bulgaria and its economic agents in comparison with other WTO members resulting from this liberal regime. This situation currently places Bulgarian SMEs in an unequal position on international markets.

Under the provisions of the **Agreement on Bulgaria's Accession to the EU**, Bulgaria and the Community undertake to establish a **free trade zone** within the framework of a transitional ten-year period, and in correspondence with GATT provisions. Customs duties and reciprocal charges for Bulgarian industrial products have been canceled as of January 1, 1998, and as of January 1, 1999 the quotas for Bulgarian textiles have also been removed.

Agricultural trade between Bulgaria and the EU is based on reciprocal preferential tariff quotas, which provide an improved market access. As a result of the complete lifting of customs duties and reciprocal charges, a free trade zone for industrial products was set up. All of this has had the respective effect on the volume of trade between Bulgaria and the EU. The improved access to the Community market that has resulted from signing the Association Agreement has led to a substantial change in the geographic structure of Bulgarian trade. EU countries have become the major trade and investment partners of Bulgaria (accounting for 51.8% of Bulgaria's overall volume of trade, including 48.6% of total imports, and 52.6% of total exports).

Between 1992 and 1999, the total volume of reciprocal trade nearly doubled, reaching USD 4.7 billion, compared to the USD 2.5 billion in 1992. During the first half of the period, the increase in trade was mainly due to increased Bulgarian exports, whereas the second half of the period is characterized by a stabilization in exports and an overtaking growth in imports. Thus, over the entire period, Bulgarian exports have shown an 80 % growth, while imports from the EU rose by 90 %.

The effect of the Agreement is less clearly expressed in the exports of agricultural products. In spite of the reduced level of customs duties and the equalizing charges within the framework of fixed quantity quotas, in recent years, the relative share of agricultural exports exhibits a declining tendency at the expense of agricultural imports from the EU countries. In many instances, tariff quotas have remained underutilized, since the reduction in custom duties and equalizing charges has proved insufficient to make Bulgarian goods competitive and to stimulate agricultural exporters and producers.

The increase of the EU share in Bulgaria's exports can be largely viewed as an expression of the successful adaptation of Bulgarian industry to the requirements of the West European market. However, a large number of SMEs do not realize fully the implications of the European

Agreement and the prospects offered by the future integration for their own business<sup>9</sup>. The liberalization of trade with the EU offers vast opportunities for Bulgarian SME sales and for their internationalization. At the same time, however, it brings them face to face with the necessity to deal with the increased burden of non-tariff barriers and the stiff competition of local SMEs, which are the target of consistent support efforts on the part of the Community.

The **adaptation of Bulgarian producers and exporters to EU requirements** could not take place without the active intervention by the state. This intervention has the form of simplification of administrative and legal environment for business development, an improvement of the financial environment and expanding SME access to financing, enhanced access to new markets, training in marketing and quality management, and urgent introduction of the respective European standards. The survival of Bulgarian SMEs on the integrated European market will very much depend on the improvement of their organization and strengthened cooperation among them. The most important condition remains the increase of their competitiveness through upgrading the technologies based on incentives for their participation in research and development, innovation and training.

Bulgaria is party signatory to the **Multilateral Agreement on Free Trade of the EFTA Member Countries**, which includes Switzerland, Liechtenstein, Norway and Iceland. According to the Agreement of January 1, 1998, import of industrial goods of Bulgarian origin into EFTA is duty-free.

With the signing of the **Agreement on Bulgaria's Joining to the Central European Free Trade Agreement**, the parties undertook to remove gradually, within a transitional period, all import and export duties, reciprocal charges, the quantitative restrictions and reciprocal measures, and not to introduce new ones in their mutual trade. The fulfillment of this commitment with regard to the specific goods and time frames for removing customs duties is negotiated bilaterally. Thus, from the beginning of 1999, the duties on more than 80% of industrial goods traded have been lifted. The rates for the remaining goods have been reduced (between 25 and 60% of the base duty charges), with the prospect of gradually eliminating them in the future. As of the beginning of 2002, trade in industrial goods among the member countries is expected to become completely duty-free.

Bulgaria's membership in CEFTA provides it with free access to a 100-million market, and the opportunity to undertake coordinated efforts and joint ventures with regard to third countries, and participation in a number of important international economic organizations.

Southeastern European countries occupy an important place in Bulgarian foreign trade not only because of their relative share (17 - 18%) but also because of the considerable positive balance of trade for Bulgaria. In July 1998, an **Agreement for the Creation of a Free Trade Zone with Turkey** was signed. In 1999, an **Agreement on Free Trade with Macedonia** was signed. Negotiations for the creation of free trade zones with other Balkan countries are still at the stage of feasibility studies in anticipation of a more substantial development. Intensive work is in progress on the preparation of new **Agreements on Free Trade with countries outside the region** such as **Israel, Morocco, Lithuania, Latvia and Estonia**.

There is a prevailing opinion among SMES that a **pro-active policy of export promotion is non-existent**, and that the significance of export as a key factor in achieving growth is being neglected. Actual results indicate that, no purposeful policy is being pursued towards setting up the

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<sup>9</sup> *SMEs in Bulgaria, 1996 - 1999 Report*, Bulgaria, Agency for SMEs, FED, CED, 2000.

conditions that would encourage Bulgarian exports. The public does not exhibit any clearly expressed interest in developing a national strategy promoting exports and in improving considerably the efficiency of existing government agencies already tasked with such efforts.

These include the Center for Export Promotion, the Agency for Export Insurance, etc. Presently, the only way in which export is being encouraged is by ensuring better access for Bulgarian goods to international markets, through the conclusion of bilateral and multi-lateral agreements. Yet, there is no formulation or pursuit of any definite industrial and trade policy to identify and promote the export of competitive products.

Underdeveloped economies, which have a need for rapid economic growth in order to achieve a certain level of development, typically implement an export-oriented policy of opening up the economy and encouraging competitive exports. The formulation of priorities in any policy does not imply discrimination or protectionism but, rather, a comprehensive approach to processes in their integrity and dynamics.

**Bulgaria still lacks a foreign trade strategy and a complete effective policy for opening up its economy**<sup>10</sup>. This is the conclusion made in the latest European Commission Report on Bulgaria's Progress towards EU Accession. Such a strategy would help in finding the optimal balance between protectionism and liberalization and reaping the benefits from balancing internal and external priorities. Actually, such a strategy does exist. However, since there is still an avoidance to outline, at the government level, Bulgaria's export profile and government commitments to the development of such an export profile, it remains only a document of wishful thinking.

Analysis of the **volume, dynamics and structure of trade** makes it possible to trace the substantial changes occurring over the past years and draw the respective conclusions as to the potential of SMEs and their competitiveness. During the 1992 - 1999 period, the volume of trade rose by 12.5%, from USD 8.4 billion to USD 9.4 billion. Over the same period, exports have increased by only 1.2% to USD 4 billion, whereas imports have shown a marked increase of 22.4%, reaching USD 5.5 billion. In 1999, Bulgaria reported a negative trade balance again, the highest since the beginning of the period, to the amount of USD 1.5 billion. As of June 2000, the balance of trade was negative again, and amounted to USD 819 million.

What could and should be done for SMEs in that field? Small and medium-sized companies are especially vulnerable to the **non-tariff barriers** before Bulgarian exports. For example, a frequent requirement is that SMEs should get certified for having introduced quality management systems under the ISO 9000 series. As of August 2000, only 250 enterprises held such certificates. The certification process itself requires the participation of consultants and certifying organizations. This creates difficulties for the companies, both due to the time it takes (at least one year) and because of the costs involved (several thousand dollars). An industry-specific approach to certification paired with direct and indirect assistance within the framework of international projects could considerably improve the competitiveness of Bulgarian SMEs.

The market requirement for holding a national identification number for the purposes marking goods, known as a 'bar code', is also particularly important for firms offering consumer goods. This service is provided in Bulgaria at dollars prices, and represents another considerable cost to small enterprises. Any form of reducing this cost would definitely serve to increase SME competitiveness.

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<sup>10</sup> 1999 Regular Report of the European Commission on Bulgaria's Progress towards Accession.

The **trademark** registration and all other activities related to **intellectual property rights** are also very costly services without which Bulgarian SMEs would not be competitive. This question stands out with particular acuteness for outward processing firms. They must plan ahead for the future and use their experience gained in outward processing to set up a trademark of their own and launch their own products. This need stems from the fact that only a in few years, when bilateral commercial relations between the EU and China get optimized and quotas and other restrictions get eliminated, any advantages of outward processing still existing at this stage will be lost.

These three examples looking at the inconveniences created by ISO 9000, the bar code and trademarks indicate the need to develop a national system for efficient servicing of SMEs. Only the executive level of government, working in cooperation with industry associations, can plan these processes and provide service facilitation for SMEs. The current practice rather adds to the burden on companies and hampers them from achieving efficient development and a fully beneficial Bulgarian participation in international markets.

Another possibility to assist SMEs in achieving competitive production of goods for export is the **development of free economic zones** (through upgrading legislation and revamping existing free trade zones). On the basis of tax and duty breaks, these could help attract foreign capital (for 'green field investments' or to existing enterprises) and create new jobs. It is well known that at present some 30% of world trade is carried out in free economic zones. They are used by national economies as an important tool in the optimization of trade, regional development support, improving the infrastructure and the business climate, accelerating the transfer of technologies and know-how as well as management experience, all of which helps strengthen and promote SME development and improve their competitiveness.

**Foreign investments** play an important role in the process of boosting SME competitiveness. It is not only a source of external financing but also a possibility for the broader introduction of new technologies and elements of effective corporate organization and governance. It helps create an innovative environment and secure markets. Bulgaria has one of the most liberal legislations on foreign investment in the region, which creates a favorable investment climate in the country. Along with regional instability, the most frequently cited reasons for the insufficient volume of foreign investment in Bulgaria include: the delay in the privatization of certain large enterprises of structural significance for the economy; the underdeveloped capital market; frequent changes in legislation as a result of the effort towards harmonization with European and international standards; the existence of red tape procedures, which hamper and delay the implementation of investment projects; limited purchasing power of the population; the existence of surviving elements of unfair competition; widespread corruption, etc.

Part of the process of encouraging foreign investment is the work on concluding **agreements for mutual promotion and protection of investments**. To date, a number of agreements for mutual promotion and protection of investments have been ratified, signed or drafted with a number of countries. A series of agreements, accords and memoranda of cooperation, technical and financial collaboration agreements have been signed as well, which help the process of attracting foreign investments to Bulgaria.

A necessary prerequisite for the attraction of foreign investment is the summarization of success stories in competitive industries, involving SMEs, which can be used both by the government and branch associations in attracting investments. This information should be distributed in print and on the web pages of industry organizations on a permanent basis. The

Foreign Investment Agency, the Center for Scientific Information, the Agency for SMEs, as well as the commercial offices of the Ministry of Economy should distribute them jointly through regular Bulgarian participation in specialized trade fairs and exhibitions. As a rule, small and medium-sized companies have neither the financial nor the human resources to do that constantly. This effort should occur in a planned, coordinated and mutually complementing way.

Another important investor requirement should also be kept in mind - the existence of investment plans prepared by companies and outlining the vision of their management as to business development and expansion of operations, the company appearance after the investment takes place, and the envisioned benefits to the foreign investor.

At this stage, **the market in Bulgaria can be considered fully liberalized**. However, steps should be taken to protect the national market from unfair competition coming from illegal imports. It is necessary to have an in-depth analysis of the real inflows and outflows, the reasons for the differences that have emerged, the actual degree of protection of the domestic market and the effective customs duty burden. This analysis should be made jointly with the government and branch associations in order to gain a clear understanding of the contradictions between the proper macroeconomic steps and their real impact on the microeconomic environment.

SMEs particularly suffer from the **lack of accessible information** about tariff measures in place in our country, and those applicable to Bulgarian goods on international markets, as well as multilateral agreements, international, regional and bilateral agreements, so that they may take advantage of the opportunities for preferential trade. Both government and non-government entities which service SMEs should join their efforts to create an integrated system of information support for SMEs. This would increase the efficiency of government administration on the national scale.

There is also a lack of organizations at the national level to provide **consumer protection**, a lack of established certifying bodies, internationally accredited laboratories, etc. This leads to the need to use the services of foreign institutions and, consequently, to higher export costs. Export has not yet been given the status of a national priority. Business and professional communities unanimously agree that government administration is still reluctant to realize the need for a **pro-active support for competitive export** and its producers, and for the attraction of strategic investments in certain activities in order to stimulate economic growth.

## **TAX POLICY TOWARDS SMALL AND MEDIUM-SIZED ENTERPRISES**

In terms of tax legislation, the revision of the legal framework for promotion of an independent business activity has had a particularly adverse effect on economic agents' ability to implement **tax planning**. In the present conditions, tax planning is an essential business strategy in the economic development of any company. It requires clear and accurately codified tax rules and tax laws, unaccompanied by a set of regulations, ordinances, interpretations etc. Tax planning is a process that attempts to combine an optimum utilization of existing and potential resources within the limits afforded by tax legislation.

Tax planning is a huge business. The investments, which a company makes, depend on the manner in which they are financed. A company is considered to have adopted a "capital structure decision" when it has decided how it will finance its business. This structure leads to a definite return on investment. The corporate capital may consist only of securities (including various types of stocks, common and preferred ones) or of a combination of equity and debt. The question whether to use debt or equity when incorporating a company or later on for its operation depends

directly on the company's tax liability. This is even a form of tax planning, provided there are clear and fair laws that will function for a number of years rather than months without being amended.

In all developed market economies, tax legislation amendments enter into force six months or one year after enactment, enabling economic agents to adjust to the new environment, to seek new forms of tax planning, and to evolve new business strategies. Moreover, after new tax laws are introduced, their operation is monitored for nearly a year before making any revisions or before estimating the revenue, which they would generate.

The adoption of a law is a complex and dynamic process rather than a one-off act. The enforcement and application of a law is a far more complicated and time-consuming process than its enactment. Tangible results take even longer in coming, and a dramatic revenue impact cannot be expected overnight. Information, the essential asset of any business, is very important to tax planning. Information must be readily available to every taxpayer, and its provision must be even mandatory, it must come from a reliable source, in an appropriate format, and be broadly published.

The financial regulatory framework has stabilized to a certain extent as a result of: the establishment of bodies monitoring the degree of harmonization of Bulgarian draft statutory instruments with the effective legislation in the EU Member States; the adoption of the National Budget Procedures Act, which requires amendments to the tax laws to be effected before the beginning of the budget year; and the adoption of new laws regulating previously unregulated relations (e.g., the Public Procurement Act). Nevertheless, legal framework stability has yet to attain a mode that would turn it from an obstacle to business development into a guarantee of the success of the economic reform and transition to a market economy.

These adverse influences of the **volatile legal environment** affect all economic agents in Bulgaria. But while large enterprises and established holding structures possess the necessary economic and human resource potential to cope with and overcome these difficulties, SMEs, due to their size and the resulting peculiarities, are far less capable of adjusting and carrying on successful business. While spared direct statutory or administrative discrimination, SMEs remain subject to unequal treatment, which distorts the competitive environment for business. The need to redress this inequality raises again the question of the form of assistance sufficient to avoid the discrimination of SMEs: whether it is sufficient to ensure a stable regulatory environment for the conduct of business, or it is necessary to extend special preferential treatment to SMEs such as direct state aid, privileges in special competitive bidding procedures etc.

Bulgaria's effective legislation has yet to be revised, especially with regard to the framework of the ongoing tax, social and health reforms. When specific proposals for amendments are elaborated, the point of departure should be primarily the "Think Small First" concept, since large companies will cope with the legislative provisions drafted in consideration of the interests of SMEs, while the opposite is not the case.

The Government may choose to apply **comprehensive tax measures** (e.g. lowering profits tax for small businesses), in order to eliminate the combined impact of numerous (tax and non-tax) factors that hinder growth in the SME sector. Tax measures, however, could be part of a larger package which could also include other, non-tax, schemes or measures (e.g. support for training in accounting or planning), which would reduce expenditures on tax management (costs that sometimes are prohibitive for small-sized enterprises).

The creation and development of a **tax system** in Bulgaria is intended to bring taxation in conformity with market requirements. This system must service the various existing forms of

ownership, while at the same time promote non-inflationary financing of the budget and public expenditures, so as to implement a modern social policy. Taxes must be levied to regulate the investment behaviour of individuals and not to stifle any entrepreneurial initiative.

In Bulgaria, the taxation of small and medium-sized enterprises does not differ from the standard taxation. Those registered as sole traders (which does not always mean that they are SMEs) are obliged to make tax prepayments throughout the year under the Corporate Income Tax Act, and their annual taxable income is taxed under the Personal Income Tax Act by the so-called "lump-sum tax." The Corporate Income Tax Act provides for a single concession to the so-called "small companies:" if their taxable profit does not exceed 50,000 leva, they pay corporate tax at a rate of 20%. Apart from these measures, there is no possibility for small and medium-sized businesses in this country to benefit from any tax relief.

This paper attempts to examine the opportunities for **SME promotion through improvement of the tax environment** in terms of the tax treatment of these companies and the opportunities to establish a preferential treatment for this sector.

**Income taxation** is a key tool of economic control, a way to justify economic inequality. Income is a suitable tax base, but its scope should be defined accurately and clearly.<sup>11</sup>

What all these schemes share in common is the designation of a given proportion of income as return on capital, based on capital assets of the enterprise. Such a system openly acknowledges the duality of income in the small-sized enterprise, as return on capital and as remuneration or wage for the work done.

In principle, income could be subdivided into two basic groups:

- (a) income from land, from manufactured tools, from consumer capital, from the exercise of various rights;
- (b) income from operations (transactions), comprising income from interest, from dividends and other financial operations.

All these types of income can be got either by natural or juridical persons, depending on the legal form of accrual. On these grounds, we can define personal income as an algebraic sum total of, (1) the market value of rights exercised upon consumption and, (2) the value adjustment of ownership rights held during a given period of time.

Almost all developed countries use income taxation as part of the ways of collecting revenues for public purse, but it varies substantially by structure and size. In most general terms, **juridical persons are taxed at a flat rate, whereas natural persons are taxed at progressive rates**. In the former case the income is from capital<sup>12</sup>, and in the latter - from exercise of certain rights.

Sole traders account for their income according to the Corporate Income Tax Act but are taxed under the Personal Income Tax Act (PITA). This is a strange discrepancy, which must be

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<sup>11</sup> In this context, the definition provided by American author Hewett is very accurate: "Net individual income is the flow of goods and services acquired by an individual over a definite period of time, and available for consumption after deduction of the necessary costs for their acquisition". (W.W. Hewett, *The Definition of Income*, Philadelphia, 1925, p. 22-23)

<sup>12</sup> Sources refer to this tax variously as "capital income tax," "tax on profits," "corporation tax" etc.



eliminated. A sole trader who qualifies as a small-sized, low-income-earning entity, should be treated as self-employed and be taxed under the PITA, whereas a trader who controls substantial capital and employs workers should be taxed under the Corporate Income Tax Act. Otherwise, a sole trader making prepayments under the Corporate Income Tax Act (CITA) may overpay his or her annual tax liability because the prepayments do not correspond to the tax threshold under the PITA. Moreover, additionally accruing income, also known as "fringe benefits," is not regulated. The inclusion of fringe benefits into the tax base is necessary not only in order to attain horizontal equality but also to prevent disruption of the compensatory basis of fringe benefits in money equivalent.

In Bulgaria, the system of **fringe benefits** is not well developed and has yet to be covered by the tax laws. Definite rules exist for per diem and accommodation expenses during business trips, for local transport, for social and health insurance, but this applies mainly to recipients of income from business, i.e. the relief is limited to the employer, but nothing is mentioned about organization of a company kindergarten or payment of kindergarten fees by the company on behalf of the employees, use of company cars for personal needs, or soft company loans for employees' housing constriction or certain other perquisites for company employees which, in the present economic situation, are far more important than the wage itself.

**Corporate income tax** is important, as companies are very influential social and economic institutions. The role of corporate profits tax in various countries depends on the forms of taxation, as well as on its correlation to personal income tax. At one end of the spectrum, the corporation is treated as a juridical person, completely distinct and separate from its shareholders and owners, and it is taxed as such - the so-called "classical system of taxation."<sup>13</sup> In this case, the accrued income is taxed twice if distributed: once at the corporate level, in the form of profits tax, and once again at the shareholder level, as personal income tax. The existence of a separate corporate income tax implies that dividends are overtaxed compared with the other income from capital, such as interest.

Most European Union Member States apply, apart from the standard corporate income tax rate, a reduced rate, depending on the income. The tax relief is undoubtedly instrumental to the share of small and medium-sized enterprises in these countries. In some cases, tax relief covers comprehensive encouragement of a definite sector or product line (Greece) or region (Ireland). In most countries, particular attention is paid to small business, and various forms benefiting it are adopted.

**Depreciation deductions** for taxation purposes are another widely used tax policy instrument. In all developed market economies, accelerated depreciation is regarded as one of the possibilities to encourage investment, and the tax assessment base is revised accordingly. All innovations, technological renovations etc. are effected on the basis of changes precisely in depreciation quotas. These tax reliefs and incentives are intended to improve the business climate for small and medium-sized enterprises, and to optimize the use of tax levers for promotion of entrepreneurship.

As far as **indirect taxation** is concerned, and more specifically the established system of **value added taxation** (VAT), its impact on SMEs ought to be considered in two aspects. On the one hand, the Bulgarian VAT system should be incorporated into the Common system of value added tax introduced in the Single Market. The purposes of this system are: to ensure equal

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<sup>13</sup> See Sijbren Cnossen, "What Kind of Corporation Tax?" in *Key Issues in Tax Reform*, ed. Cedric Stanford, Fiscal Publications, 1993, UK, pp. 41-43.

treatment of trade in goods and services on the common market and the national markets, so that SMEs could operate freely throughout the Community from their fixed establishment without encountering additional administrative difficulties; to reduce misunderstandings and complexities in VAT taxation by providing business with a Common system of value added tax, equally applicable and satisfying the requirements of a genuine common market; to reduce misunderstandings caused by different interpretation of the rules. Establishing a Bulgarian VAT system in accordance with the Common system of value added tax for the Single Market will create, on the one hand, the required stable tax environment and, on the other, will facilitate Bulgarian SMEs in their foreign trade. Besides this, however, taking quick-start legislative measures directly geared to SMEs is also necessary, considering the need to promote SMEs and eliminate the discriminatory aspects of VAT taxation, given that this tax is oriented towards larger enterprises.

The effective system in Bulgaria qualifies VAT primarily as **a tax for the "big ones."** SMEs are treated rather as mere bearers of the tax burden, but not as persons liable for tax. Persons with a 12-month taxable turnover below 75,000 leva cannot register for VAT, and they therefore incur no liability under the VAT Act but, at the same time, they cannot enjoy the rights conferred under that law. The effect of this system varies by enterprise in the sector. Some benefit from the high registration threshold, insofar as the business they carry on is not affected by the fact that the enterprise is in practice excluded from the range of persons liable for tax. These are retailers, handicraftsmen, service providers working on their own etc. They would be seriously burdened by any lowering of the registration threshold, and such a change would have to be introduced in conjunction with relief in rules for VAT accounting. Insofar as the lowering of the so-called **registration threshold** is one point of the Bulgarian VAT Act that needs to be revised in the process of harmonization of national legislation with EU law, models of relaxed VAT tax treatment will have to be elaborated.

For another group of Bulgarian SMEs, however, the inability to register for VAT before their annual taxable turnover reaches 75,000 leva presents a problem which holds back their business development. These are mainly manufacturing and newly established enterprises. For manufacturing SMEs, the problem arises mostly when their output is part of a consumer-good production chain. In such a case, the enterprise purchases equipment for its manufacturing operation and raw and prime materials, paying on them VAT when it imports them or purchases them locally, but has no right to credit for input tax and has no right to charge VAT. If the customers of the enterprise are persons who are not end-users of the goods but use them as intermediate goods and are registered for VAT, it will be unprofitable for such customers to do business with such an enterprise because the end price of their goods will cumulate VAT higher than the standard 20% rate and this will make their output too expensive and non-competitive compared to other similar goods on the market. Another adverse effect is the impossibility to deduct the net input tax, paid by the enterprise upon purchase of equipment, raw and prime materials. The mechanisms provided for in the VAT Act to neutralize this adverse effect are inapplicable to most SMEs, and they are thus compelled to seek other means to eliminate the constraining impact of the established VAT system. Extension of the established system of voluntary registration could solve these problems. The effective restrictions on the possibility of voluntary registration are prompted rather by considerations to facilitate the administration of the tax. With fewer registered persons, the proper functioning of the tax mechanism is easier to control and allows the administration to concentrate on the larger taxpayers, which deliver the bulk of budget revenues. At the same time, however, this places SMEs at even more unfavourable conditions.

Another very substantial adverse effect is exerted by the way in which the rules for **the right to credit for input tax** have been established. The provisions, which lay down these rules, change every tax year, tending to place persons liable for tax in an increasingly unfavourable position. The registered persons' position is complicated still further by the fact that non-conformity of a supplier in a given supply will be discovered much later, if the tax administration conducts an audit. These changes affect all persons registered for VAT purposes, but they again load the dice against SMEs. These adverse impacts on both the economy and the economic agents themselves can be avoided if the statutory rules require the tax administration authorities to keep track of the law-conforming conduct of registered persons and the discharge of their liability to the Exchequer.

The unending amendments to the VAT Act make it impossible to establish a clear tax treatment in Bulgaria and to reduce administrative obstacles to business, as required within the EU. Different systems and treatments are applied in the different EU Member States to encourage certain SMEs: relieved treatment, simplified treatment, deduction etc. The establishment of certain relieved treatments applied by the tax systems of the Member States, such as equalization tax, lump-sum tax treatment, average rate taxation, could be considered in case of lowering the registration threshold, which is part of the EU's general recommendations for the process of harmonization of Bulgarian legislation with EU law, but it will affect small business adversely.

Countries applying VAT have a common practice of **at least three rates**: a zero rate for exports, a standard rate, and exempt supplies, as is the case in Bulgaria. The difference is that zero-rated transactions carry the right to credit for input tax whereas exempt supplies do not confer this privilege. For this reason many economic agents prefer to be zero-rated than to be treated as providers of exempt supplies. Moreover, in the developed countries some even prefer the standard rate to exemption from VAT, because this is a tax ultimately paid by the consumer, not by the manufacturer or trader. The numerous rates leave the impression that value added tax is more neutral than income taxes, and stronger incentives are thus offered for saving, investment and production. VAT minimizes possibilities for tax evasion and concealment of taxable income.

## GOVERNMENT INSTITUTIONS CARRYING OUT THE STATE POLICY TOWARDS SMALL AND MEDIUM-SIZED ENTERPRISES

The functions of the State in wielding state power are performed by the state apparatus, which is the system comprising all state bodies: the legislative, the executive, and the judicial authorities. The totality of public administrative bodies, including the local administration authorities, forms the **administrative apparatus of the State**. Public administration is the system of public executive authorities, which carry out administrative activities and perform the functions of the State with regard to SMEs. These are the administration of the Council of Ministers, the ministries, the state agencies, the state commissions and the executive agencies, as well as those of the local administration: the regional and the municipal administrations with their apparatus, functions and operation. The legislative framework of this system is laid in Articles 36, 37 and 38 of the Administration Act.<sup>14</sup>

**The organizational structure<sup>15</sup>** of public governance is hierarchical in nature.<sup>16</sup> The hierarchical arrangement, the existence of many levels of governance, ensures implementation of a uniform state policy towards SMEs, complementarity of local interests with the common objectives, and reconciliation of the needs of the separate territorial units with the national needs and interests and vice versa. This arrangement creates conditions for operational autonomy of the separate levels in the public administration system, and for efficient control of each level, making the system flexible and more resilient to external impact.

Several types of structural units have been established in the public administration system: directorates general, directorates, divisions, sectors, and services. Two groups of governance activities are differentiated in each public administration authority, performed respectively by 'order-taker' units and 'order-giver' units.<sup>17</sup>

The 'order-taker' units are formed according to their specialization, whereas the 'order-giver' units within the governance system of an institution are distinguished according to the internal governance mechanism. That is instrumental in the "aggregation" of the 'order-taker' units into

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<sup>14</sup> *Official Gazette* No.130 of November 5, 1998.

<sup>15</sup> In an organizational structure, the elements of the system are forms of organization of definite characteristics. Such elements in the public administration system are the directorates general, the directorates, the divisions, and the sectors. Their links are organizational in nature. The links characterize, first, the state body itself as a whole, both its structure and its capability to function in a definite manner; secondly, the relationships between its structural units on the basis of distribution, hierarchy of rights and responsibilities, of the right to final decision-making on a definite problem, of the right to coordinate, evaluate and control the performance of the individual order-takers, the choice of priorities etc. Organizational links, therefore, characterize the structure of governance as power. These are links characterizing the governance of the very process of collection, processing and transmission of information reflected in the technology of governance, i.e. they characterize the management of the governance process. The governance process is implemented as a result of collective, joint work. This is precisely why governance itself has to be managed, the so-called "meta-governance." Meta-governance is the essence and underlying content of organizational links.

<sup>16</sup> A hierarchical structure is shaped either as a vertical chain of command or, most often, as a pyramid. It usually has numerous levels: governing, functioning, intermediate and operative. The subordination of levels in an organization is based on the different significance and position of each level in the hierarchical arrangement. The operation of inferior elements in the system is determined by the decisions of superior elements.

<sup>17</sup> Both types, however, are governance units, and the difference in their designation merely emphasizes the nature and intended purpose of the functions they perform.

larger structural units (thus, divisions aggregate into directorates) and in building the levels of internal hierarchy.

The problems of **hierarchy** as an organizational structure in public administration are related to the determination of relationships between superior and inferior units, and to the granting of a measure of autonomy to the individual units and levels. In the organizational structure, powers are distributed vertically on the basis of **centralization and decentralization** in the organizations and are defined in the Administration Act.<sup>18</sup> Centralization is concentration of the processes of decision-making in the superior levels of public administration, which is a way to avoid conflicts and contradictory interactions between the decisions of the different public administration authorities and an inefficient duplication of their operations. Decentralization manifests itself in two main versions. One is when the distribution of decision-making powers and responsibilities is devolved to inferior state bodies or to the structural units within a single state body. The other type of decentralization is spatially conditioned. The individual units, although of the same level, are spatially remote and detached. Decentralization in public administration is inextricably linked with the right of the public administration authorities to a choice of action, and it is a manifestation of operational autonomy.<sup>19</sup> Operational autonomy is the opportunity granted by law to a state body to decide whether and when, how and what decision to make in the performance of a function within its competence. Unless operational autonomy is provided for the acts of an administrative authority, it acts in conditions of "bound administration" or "bound competence." In the case of "bound competence," the legal standard categorically limits the administrative authority to a single possible decision which the authority is bound to make if the prerequisites provided for by the law exist.<sup>20</sup>

Computerization and information globalization have outlined a new, reverse tendency of **re-centralization**. Information technology creates conditions for centralized virtual exercise of governance functions and helps re-centralize the decisions that regulate functionally the widely dispersed and numerous decentralized organizations and the interconnections between them.

Specifically with regard to SMEs, an example and confirmation of this re-centralization is a provision of the Small and Medium-sized Enterprises Act. It regulates the building and maintenance of an information system by the Agency. That system is part of the communication and information infrastructure of the administration of the executive authorities, as well as the building of a national information network for SMEs.<sup>21</sup>

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<sup>18</sup> *Official Gazette* No.130 of November 5, 1998.

<sup>19</sup> Or discretionary administrative power, or administrative discretion. Discretionary administrative power delimits the freedom of judgment of the administration. In Bulgarian administrative law theory, discretionary administrative power is termed "operational autonomy."

<sup>20</sup> In the cases of "bound competence," the administrative authority has no possibility (lacks discretionary power) to judge and adjust its behaviour to a specific case. The authority does not evaluate the actual situation so as to decide whether and how to act. The authority verifies the existence of the prerequisites provided for in the legal standard, and if the authority ascertains their existence, it acts in the manner prescribed to it by the law. In the case of "bound competence" there is a certain measure of automatism in the correlation between law and administrative activity. There is no creative initiative and reckoning with the specific situation. A classical example of "bound competence" is the operation of the tax administration, i.e. it functions as a "bound administration".

<sup>21</sup> See Article 8 of the Small and Medium-Sized Enterprises Act, *Official Gazette* No.84 of September 24, 1999.

**Coordination** in the decision-making process within public administration is manifested in the establishment of rules prescribing to the separate state bodies and their structural units the modalities of their decision-making in order to harmonize their action regarding the development of the SME sector. Coordination involves balanced adaptation and reconciliation of the interests and operation ("behaviour") of public administration as a system, and of the non-governmental organizations (NGOs). Coordination is achieved through the establishment of special coordination bodies, such as councils, commissions, interdepartmental working groups with the Council of Ministers, certain line ministries (the Ministry of Economy, the Ministry of Labour and Social Policy, the Ministry of Regional Development and Welfare, the Ministry of Agriculture and Forestry), state agencies (the Agency for Small and Medium-Sized Enterprises, the Bulgarian Foreign Investment Agency), executive agencies and centres, regional administrations and municipal councils, whose purpose is to coordinate the actions of state bodies and organizations both within the framework of the public administration system,<sup>22</sup> and with the organizations of the non-governmental sector.

Coordination mechanisms are an aggregate of methods and means of achieving coordination. They are evolved, developed and abandoned depending on the changes in economic and administrative conditions. They could be subdivided into:

- Economic-based coordination mechanisms;
- Administrative-based coordination mechanisms;
- Programme- (project-) based coordination mechanisms.

Public administrative authorities are grouped into various types, depending on different criteria.

- ***According to the nature and scope of competence<sup>23</sup>***: authorities of general competence and authorities of specific competence. With regard to SMEs, competence tells the interested parties: companies, entrepreneurs and their associations and organizations, who has the right and the duty to address and decide the range of matters that concern them directly or indirectly. Competence is manifested in several kinds: material, spatial, and personal.<sup>24</sup>
- ***According to the organizational structure***: specialized and general administration.

There is a direct link between the scope of control and the number of hierarchical levels of organization in the Council of Ministers, the ministries and agencies, defined in the Administration Act. The scope of control is one of the main factors, which determine the actual boundaries of horizontal structuring by unit. If we assume that an executive agency has three hierarchical levels

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<sup>22</sup> For further detail, see "Coordination Bodies" in Part 3 "Organizational Structure of State Administration and Its Impact on SMEs".

<sup>23</sup> Competence of the state bodies is an expression of the specialization of the functions of public governance. This competence outlines the range of tasks for performance of the functions of State entrusted to the separate authorities. Competence could be defined as a system of powers, i.e. an aggregate of rights and duties of a special nature conferred on the authority for the purpose of wielding state power.

<sup>24</sup> Material competence refers to a range of issues designated by subject matter. It is defined in terms of subject matter and is therefore also known as subject-matter competence. It expresses the specialization of the individual authorities by area of responsibility. A definite administrative authority is competent to issue acts and perform actions within a scope of public administration defined by subject matter. Spatial competence refers to the spatial scope of the authority's powers to act, reflected in its competence. There are central and local authorities. The powers of each administrative authority can be exercised within definite spatial boundaries. Personal competence, which is sometimes called competence by degree, refers to the scope of powers of the individual administrative authority depending on the position of the authority within a given administrative organizational system.

on the average, a state agency has four, a ministry has five, and the Council of Ministers has seven,<sup>25</sup> this means that **the system of public governance within the framework of, say, the central public administration, consists of nineteen hierarchical levels.**

One of the contributions of the law is the statutory regulation of state agencies and executive agencies. They express decentralization in governance, on the one hand, and an objective regularity according to which public administration increases the number of its own hierarchical levels at each new stage of development.<sup>26</sup>

This study has identified a total of **309 structural units having an administrative impact on SMEs.**

The Council of Ministers is vested with the broadest authoritative powers of a regulatory nature. Operational functions are devolved so as to relieve the Council of Ministers of day-to-day operational work and allow it to concentrate on the important matters within its competence. In performing its functions,<sup>27</sup> the Council of Ministers is assisted by bodies such as ministries, state agencies, commissions and councils and, acting on their motion, determines (by statutes) the organization and procedure of their operation.

These units prepare observations on draft instruments concerning SMEs and submit them for consideration to the Council of Ministers, they examine the documents submitted to the Council of Ministers by inferior public administrative authorities and the regional administrations; they gather and analyze information, arrange the preparation of the necessary analytical and reference materials on the state of the business environment, including the tendencies in the development of small and medium-sized businesses in Bulgaria.

The structural units having a direct impact on SMEs (directorates general, directorates and divisions) are concentrated mainly in several ministries: the Ministry of Economy, the Ministry of Finance, the Ministry of Agriculture and Forestry, the Ministry of Regional Development and Welfare, the Ministry of Labour and Social Policy, and the Ministry of Transport and Communications. The Ministry of Foreign Affairs and the Ministry of Environment and Water have a more limited, albeit important, influence on the development and implementation of the state policy towards SMEs.

The ministries concentrate the largest number of structural units having a direct impact on SMEs. More than three-quarters of them perform standard-setting, controlling, registering, analytical and planning functions and activities for the sector of small and medium-sized enterprises.

After the ministries, the next largest number of specialized structural units having a direct impact on SMEs is in the state agencies, commissions and central-government departments. The

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<sup>25</sup> The single-person governance authorities are also included in these levels.

<sup>26</sup> It could be inferred that stages of development and hierarchical structure are directly related. The increase in the number of levels should be seen rather as a phenomenon accompanying organizational development, but by no means as a criterion under which the development of public administration as a system could be judged.

<sup>27</sup> Two statutory instruments regulate the competence, work organization, structure, composition and functions of the Council of Ministers administration: the Administration Act, promulgated in the *Official Gazette* No.130 of November 5, 1999, and the Rules of Organization of the Council of Ministers and of the Administration Thereof, promulgated in the *Official Gazette* No.103 of November 30, 1999, last amended in the *Official Gazette* No.27 of March 31, 2000.

executive agencies and centres provide administrative, marketing and advertising services to SMEs.

**Spatial governance** is decentralized public administration. It is exercised in two forms:

- state administrative governance by district, which represents decentralized state administration and is exercised by local bodies of central government: the district administrations;
- local self-government, which expresses decentralization of state power and is exercised by bodies of local self-government, i.e. bodies which are elective and which service mainly the local community: the municipal administrations.

An essential tool for the application of state regional policy within the meaning of the Regional Development Act is the National Plan for Regional Development (NPRD), which is elaborated for a seven-year period.<sup>28</sup> The constituent elements of the NPRD are the regional plans for development, elaborated by the regional administrations. The main responsibility for these plans, as well as for the implementation of an effective regional policy in their organizational structure, rests with the Directorates of Administrative Control, Regional Development and State Property.<sup>29</sup>

**Regional policy** towards SMEs is implemented by the specialized structural units in the regional administrations. These are the Directorates of Administrative Control, Regional Development and State Property. They perform exclusively controlling and planning functions with regard to the formation of the business environment and the operation of SMEs. Specialized Regional Development Sections have been set up in these Directorates. A total of 56 operative structural units are implementing the district plans for regional development. The local policy towards SMEs in the municipal administrations is based on the municipal development strategies and the programmes for the promotion of small and medium-sized enterprises.<sup>30</sup> The municipal administrations have in their organizational structure Regional Development Divisions, similar to the regional directorates. The municipal privatization divisions and agencies also have a substantial impact on SMEs.<sup>31</sup>

The state bodies and organizations appoint representatives to the interdepartmental and state-cum-public coordination bodies. Those bodies work for the achievement of common or related results in the implementation of the state policy towards SMEs. Usually, these interdepartmental and state-cum-public coordination bodies are expressly established.<sup>32</sup>

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<sup>28</sup> The first National Plan for Regional Development (2000-2006) was adopted by Council of Ministers Decree No.208 dated November 22, 1999, promulgated in the *Official Gazette* No.106 of December 3, 1999.

<sup>29</sup> These directorates are the principal type of structural and functional units in the regional administrations in accordance with their rules of organization, adopted by the Council of Ministers proceeding from the Rules of Organization of the Regional Administrations, adopted by Council of Ministers Decree No.121 dated July 5, 2000, effective as promulgated in the *Official Gazette* No.57 of July 14, 2000.

<sup>30</sup> Their elaboration and fulfilment is expressly required in Article 19 of the Small and Medium-Sized Enterprises Act, *Official Gazette* No.84 of September 24, 1999.

<sup>31</sup> They are not listed in Annex 1.

<sup>32</sup> Coordinating functions may, however, be entrusted to authorities which have already been established with a definite competence, and the coordinating function is entrusted to them additionally for handling of a specific assignment.



Naturally, no single coordination effort alone is capable of completely reconciling the global and local interests of the individual organizations, which ensue from the specifics of their tasks. Therefore, such conflicts of interest can be avoided only through regulation of the contents of the organizations' competence and of the procedure for exercise of this competence.

A total of **12 coordination councils** operate currently at the level of central public administration. Six of them are with the Council of Ministers, one with the Agency for Small and Medium-Sized Enterprises, one with the Ministry of Economy, three with the Ministry of Labour and Social Policy, one with the Ministry of Finance (General Tax Directorate), and one with the National Statistical Institute. At the local level, 28 district councils for regional development have been established, and the six commissions for economic and social cohesion of the planning regions went into operation in September 2000.

A comprehensive administrative reform was carried out during the last three years. A government strategy for establishment of an efficient state organization has been applied. The changes effected in the structure of the state apparatus, the statutory system, the rapid growth of non-governmental organizations (NGOs) and the increase of their influence provide an objective prerequisite for active interaction within the state administration system as a whole and amongst separate structural units. At the same time, the relationships between the units and the NGOs have improved, with new relations and contacts starting to take shape.

These processes are unfolding as Bulgaria progresses towards accession to the European Union. The harmonization of national legislation, the sector policies, the EU programmes and projects underway call more than ever before for building new structures and employing various coordination mechanisms (practices) in addressing the problems of small and medium-sized businesses.

## **RECOMMENDED ACTION TO BE TAKEN IN CERTAIN KEY AREAS FOR IMPROVEMENT OF THE COMPETITIVENESS OF SMALL AND MEDIUM-SIZED ENTERPRISES IN BULGARIA**

### *1. SME financing*

- Facilitate requirements to banks' capital adequacy, to the treatment of their risk exposures, and to the set up of provisions against the risk of loss;
- Establish guarantee funds with active state participation;
- Provide credit lines and schemes for loan-financing from international donors which share the risk with Bulgarian banks;
- Create special schemes for promotion of business start-ups.

### *2. Trade policy*

- Publish the conditions under which Bulgaria acceded to the World Trade Organization, as well as the original WTO agreements themselves;
- Publish the protocols to Bulgaria's Europe Agreement on trade in agricultural products;
- Publish the text of the Agreement on Accession to the Central European Free Trade Agreement (CEFTA);
- Elaborate a programme for vocational training (specialized by competitive commodities like wine, cheese, toothpaste, software etc.) in the field of non-tariff barriers to trade;
- Sign new trade agreements with Russia, Ukraine and Moldova.

### *3. Tax policy*

- Empower municipal councils to levy local taxes and charges, depending on personal income;
- Allow small and medium-sized enterprises to account for, but not pay, profits tax during first three years after registration;
- Devolve to municipal council the power to set the rate of municipal tax which, however, may not exceed 10%;
- Provide opportunities for integrated employment of persons with disabilities and transform them from consumers and users of social funds into taxpayers in their own rights;
- Transfer the regulation of the lump-sum tax from the Personal Income Tax Act to the Local Taxes and Charges Act, so as to achieve greater equity in assessing its amount;
- Make social and health insurance contributions deductible from taxable income.

### *4. Government institutions carrying out the state policy towards SMEs*

- Form new interdepartmental working groups of experts to analyze and solve specific issues concerning the business environment;
- Improve the efficiency of state-cum-public councils through formation of standing working groups of experts attached to them;
- Prepare an analysis and preliminary impact assessment (short- and long-term effect) of the separate aspects of the state policy towards SMEs and the instruments of this policy: acts of statutory and subordinate legislation, strategies, programmes, sector policies etc. Commission independent research institutes and centres to conduct surveys;
- Organize discussions with the active participation of NGOs on legislation, strategies, programmes etc.;
- Build new local structures of the public administrative authorities;

- Establish regional coordination councils for small and medium-sized enterprises as state-cum-public bodies;
- Form standing groups of experts on SMEs with the commissions for economic and social cohesion of the planning regions and with the district councils for regional development.